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May 20, 2002

Mr. Richard J. Williams, Director
Division of Economics and Finance
Virginia State Corporation Commission
P. O. Box 1197
Richmond, VA 23218-1197

Dear Mr. Williams:

Dominion Virginia Power (the Company) is pleased to respond to your request for comments and recommendations concerning the status of competition in Virginia and regional electricity markets and the facilitation of effective competition in the Commonwealth. By requiring annual reports from the Commission to the Legislative Transition Task Force and the Governor, Virginia Code § 56-596 presents an opportunity for the Commission to keep the legislative and executive branches fully and fairly informed of the key issues in Virginia's transition to a competitive market which continues through July 1, 2007. We appreciate the opportunity to offer input to this year's report.

In our response, the Company will focus on some general principles that we believe will further the development of a competitive market in Virginia in the future. These include the necessity of a robust wholesale market as a precondition for vigorous retail competition; fair and nondiscriminatory transmission access via regional transmission organizations; and the expansion of environmentally sound generation to provide the supply-rich environment needed to foster competition, as well as ensure energy reliability for the Commonwealth's future.

Central Provisions of Act Create Fair, Balanced Structure

We also think it valuable to stress that the central provisions of the Act that are effective during the transition to a fully competitive market must be preserved, in the interests of fairness and facilitating a smooth transition to competition. Modifying these critical provisions would be a far less effective means of advancing competition than would continued focus on important global issues such as wholesale market development.

The capped rate and wires charge mechanisms included in the Restructuring Act were the result of significant compromises made during the drafting of the legislation during the 1999 General Assembly session. These elements were designed to safeguard the legitimate interests of both electric customers and incumbent utilities while the wholesale and retail markets were given a chance to mature. The Commission's 2001 report itself noted that some parties were suggesting that "price caps or wires charges should be eliminated" but added that "those mechanisms were placed in the Act to protect both consumers and utilities." (State Corporation Commission Report to the Legislative Transition Task Force of the Virginia General Assembly and the Governor of the Commonwealth of Virginia, Status Report: The Development of a Competitive Retail Market for Electric Generation within the Commonwealth of Virginia, August 31, 2001 (hereafter "2001 Report"), Part III, Executive Summary, p. 1).

The caps on base rates, for example, furnish a "safe harbor" for consumers from the price volatility that may mark the development of a competitive retail market during the transition period. Customers who switch to an alternative provider may, at any time until mid-2007, return to their incumbent utility's capped rates. In Dominion Virginia Power's case, customers stand to enjoy almost a decade of such fixed rates, despite inflation, since our capped rates are based on a 1998 rate settlement with the Commission. Even customers who never switch during the transition period will still enjoy this significant price protection, and that feature was a major, and intentional, benefit of the Act. Those who suggest the Restructuring Act has yet to produce any major benefits for customers seem to forget this point.

Just as the Act sought fairness for consumers, it also sought fairness for incumbent utilities by providing them with the time and means to adapt to the new market structure after almost a century of regulation. A critical element of this fairness for incumbents is the wires charge. This is designed to assure utilities of revenue neutrality during the transition period, regardless of the level of shopping by their customers. By comparing the projected wholesale market price of electricity (the amount a utility can expect to receive for power freed by customers switching to alternative suppliers) to the generation component of the capped rates, a proper payment to the utility (a wires charge) is calculated. This mechanism keeps the incumbent utility financially indifferent as to whether any customers switch to competitive providers for generation service.

Vigorous Wholesale Market a Prerequisite for Healthy Retail Competition

As the Commission's 2001 Report noted, "[B]efore a competitive market for retail generation can develop in Virginia, it is necessary for a proper foundation to be laid." (2001 Report, Introduction, p. 3). It is the Company's firm belief that competitive retail markets will not develop effectively until the wholesale market and the mechanisms that underpin it are functioning well. The Commission's 2001 Report acknowledged this obvious nexus by stating that "[r]etail market performance is highly dependant on prices in the wholesale market." (2001 Report, Part II, p. 2).

Functioning RTO a Key to Success of Competition

A critical step toward vigorous wholesale, and thus retail, markets in the geographic area that includes Virginia is approval and operation of a Regional Transmission Organization (RTO), as called for by the Restructuring Act. The Company firmly believes that this effort is vital to effective electric generation competition. The many benefits of a properly functioning RTO include access to non-discriminatory transmission and ancillary services, standardized interconnection procedures, and access to a broad regional generation market. A fully operational RTO would provide critical support for an effective regional wholesale market. The Company commits itself to move forward toward that end, and we are confident this Commission and others will join us in our efforts. While the Company, this Commission and its Staff, the Federal Energy Regulatory Commission (FERC), and others have devoted considerable time and effort to the RTO issue, more work clearly remains to be done.

The Company is currently conducting intensive evaluations of options for RTO participation. We are trying to determine the membership that will best serve the interests of our customers, as well as the Company, and be most effective in promoting the development of a robust wholesale market.

Unfortunately, our efforts suffered a significant delay in 2001 when FERC determined that the Alliance RTO did not have sufficient size and scope, despite previous orders encouraging the Alliance effort. (*Alliance Companies, et al.*, “Order on Request for Rehearing,” 97 FERC ¶ 61,327 [2001]). The Company devoted considerable time, effort and resources to the Alliance effort and was one of the six utilities that filed applications with the FERC in June 1999 supporting the establishment of the Alliance RTO. FERC’s initial series of orders in the case encouraged the member companies to continue development of this proposal. In response to FERC’s December 2001 order, proceedings to obtain this Commission’s approval to transfer operational control of the Company’s transmission facilities to the Alliance have been suspended pending clarification of the Company’s plans, and similar proceedings in North Carolina were dismissed without prejudice.

The Company also considers the development of standardized transmission service and wholesale market design another critically important element in the development of wholesale markets. We strongly support FERC’s effort to develop sound Standard Market Design (SMD) principles. Standardization of key elements of the wholesale market will improve price signals to both consumers and suppliers of electricity, encourage infrastructure improvements, eliminate opportunities for discriminatory practices, and remove barriers to market entry.

The Company recognizes that serious issues remain concerning the proper formation and operation of an RTO for this region. Difficult questions regarding state and federal jurisdiction must also be resolved. We will work with the states and other stakeholders to find solutions to these challenges within the new guidelines set by the FERC. This solution must be in the best interests of the Commonwealth and its consumers. While we are committed to working with this Commission and other stakeholders, we see nothing to be gained, as some have suggested, by a formal and

elaborate cost-benefit study evaluating the Company's RTO membership options. This, in our opinion, would lead only to further delays.

Unsatisfactory Conclusion to Critical Step for Wholesale Market Development

Unfortunately, a vital step that could facilitate wholesale market development has not been concluded satisfactorily during the past year. This step is the issue of legal separation of the Company's generation business from its distribution and transmission operations. As I said in my letter to you of June 8, 2001, "The legal separation method is...the best way to carry out the Act's clear intent to promote development of a market in which all participants compete on a level playing field...only legal separation will provide the environment in which the Company's generation business (Dominion Generation) can realize its potential, for both customers and shareholders, in the competitive market."

However, the Commission disapproved our application for legal separation in favor of a "divisional" separation of the Company. This left us essentially in no different an organizational posture than before the case commenced. Approval of our legal separation plan would have allowed up to 14,000 megawatts of capacity owned by the Company's previously regulated generation business to participate in the regional wholesale market. At the same time, the plan would have assured economical and reliable supplies of electricity for all customers remaining with Dominion Virginia Power. The significant boost in energy and capacity offered by legal separation had the potential to promote development of vigorous wholesale competition. The effects of these improvements in the wholesale market would naturally flow into the retail market, with consumers the ultimate beneficiaries. Robust wholesale competition also would help ensure that Virginia consumers have economical power after mid-2007, when the rate caps expire and all customers have market-determined rates.

While we are disappointed with the Commission's order, we are pleased that it expressed a willingness to reconsider the legal separation issue in the future. We believe that action, with a favorable outcome, will be vital to the future development of competition in the Commonwealth. So far, two relatively small Virginia utilities have been allowed to separate their generation and delivery businesses into different legal entities, and we believe this principle must be accepted on a much wider basis if competition is to have a viable opportunity to work here. We hope to continue a meaningful dialogue with the Commission, its Staff and other interested parties on this subject. This dialogue should help resolve the state-federal jurisdictional issues that appear to be barriers to this fundamental element of wholesale markets.

Expansion of Generating Capacity Vital to Robust Wholesale Market

Finally, an important area of inquiry in Virginia Code § 56-596 concerns new and existing generation capacity. The expansion of generating capacity to keep pace with growth in demand is essential to a robust wholesale market, as well as to ensure adequate resources to sustain the state's healthy economy. Virginia is fortunate in that it has

attracted considerable interest from potential developers of many thousands of megawatts of electric generating facilities. However, investors need certainty regarding market structure. The Restructuring Act and other features of Virginia law, if properly implemented, can help provide that certainty. As the Commission has recognized, for example, it is not appropriate under the Act's provisions deregulating generation that an applicant for a permit for a new facility be required to demonstrate need for that facility.

In its most recent session, the General Assembly further clarified the permitting process by enacting Senate Bill 554 (SB 554) which specifies the respective responsibilities of the Commission and other governmental entities in the review of environmental aspects of applications for new plants and removes possible duplication in that process. It is important that SB 554 be interpreted and implemented so as to reduce barriers to the expansion of needed generating capacity in the Commonwealth.

Virginia's Transition Process is in its Early Stages

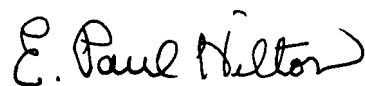
Under the responsibilities delegated to it by the Restructuring Act, the Commission has established a set of workable rules that provide a solid retail choice infrastructure for Virginia. In compliance with the Act and the orders of the Commission, Dominion Virginia Power has fully met its obligation to provide choice to its customers. It also bears emphasizing that, except for pilot programs, retail shopping in Virginia began fewer than five months ago; it will not be fully available in our own territory until the end of this year; and it will not be offered statewide until January 1, 2004. Even after that date, three and a half more years of the transition period established by the Act will remain.

In fact, this transition period, extending to mid-2007, is a central provision of the Restructuring Act. It is designed to provide enough time for development of the vigorous wholesale market essential to the success of retail competition. The creation of a functioning RTO is an imperative for an open, robust wholesale market. All three of these elements – the lengthy transition period, vigorous wholesale competition, and formation of an RTO – are linked inextricably, and all three are vital to the success of competition in the Commonwealth. The Company also recognizes that difficult state-federal jurisdiction issues confront the development of competitive wholesale markets for the supply of electricity. We will continue to work with state and federal regulators and other stakeholders to help resolve these issues.

Judgments that the market has already failed in some fashion are grossly premature. It is far too early in the transition period to reach any such conclusions, and proposals for changing the central principles of the Act should be rejected for that reason alone. Additionally, it must be emphasized that the success of restructuring cannot be gauged exclusively by the number of customers switching to competitive retail suppliers.

Thank you for the opportunity to file these comments. If I can be of further assistance as you develop your report, please let me know.

Sincerely,

A handwritten signature in black ink that reads "E. Paul Hilton". The signature is written in a cursive style with a large, stylized "E" and a long, sweeping underline.

E. Paul Hilton
Senior Vice President